R4105-80

The Conference Board

Volume 2, Number 3 March 1991

Economic Times

INSIDE:

- **Wojnilower Dissects the American Financial Zoo**
  (special center section)
- **Penner on the Marital Troubles Between Japan and the United States**
  (pages 4-5)
- **Colloquium on the Economic Impact of the Early End to the War**
  (page 3)
- **Kaufman Questions our Capacity to Prognosticate**
  (page 6)
- **Stat File and Crystal Ball**
  (pages 8-11)

Editor's Note

This month we hear from those long and widely celebrated mavens of the money markets, Dr. Doom and Dr. Gloom, by proper name Al Wojnilower and Henry Kaufman. (Were they Gloom and Doom, respectively? Or Doom and Gloom? I can never remember, but that's OK because the appellations weren't really appropriate anyway.) Al's piece, which you'll find on the shaded paper in the center is one of those thorough, impeccably logical analyses for which he is renowned. Henry's provides some brief but incisive insights on our faculty for forecasting.

Rudy Penner, another unusually perceptive analyst, explains why those who would escalate the U.S.-Japan marital spat over trade into a martial conflict ought to cool it instead. And our Colloquium panel tells us how the early end to the Gulf War changes their economic outlook.

Ed Fiedler

Cynicism of the Month:

The President and Congress haven't closed the budget gap with a value added tax because the Democrats worry that it's regressive and the Republicans worry that it's such a potent money machine. A VAT *will* be adopted as soon as the Republicans recognize it's regressive and the Democrats recognize it's such a potent money machine!

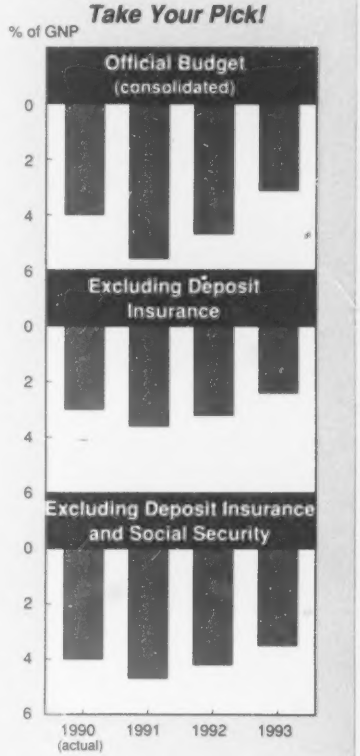
And You Takes Your Choice

There have always been different ways to look at the budget deficit, and this year the choice is wider than ever. Three popular options are shown in the chart below. The first is the official "consolidated" budget, usually a good way to view the budget, but less so now. The second excludes the amounts associated with the savings-and-loan bailout — excluded on grounds that to borrow these funds from one part of the financial system and then pay them out to another is merely a balance-sheet transaction that won't impact significantly on interest rates or the general economy. The third version also excludes the outlays and revenues of social security, medicare, and so forth, on grounds that the surpluses generated there should be accumulated to finance the extra bulge of benefits needed for retirees of the mid-21st century and thus should not be used to finance spending in the 1990s.

Which of these projections is "best?" It depends on the purpose. If you are concerned about how the budget is going to impact the economy near term, we suggest the second version. Alternatively, if what interests you is to what extent spending will have to be curbed and/or revenues increased to balance the budget *and* meet the extra needs of 21st-century retirees, then use the third version.

But if you are looking for a realistic forecast, don't depend on any of these projections, especially for the "out years." No, it's not that the politicians are playing games with the budget numbers — there's much less "blue smoke and mirrors" than in the past. The problem, now as always, is that the budget projections are based on the assumption that no additional spending programs or tax changes will appear in the years ahead. That's a necessary assumption, but it doesn't make for realistic budget forecasts. Remember Fiedler's Law (#367), "All budget surprises raise the deficit." (Well, almost all.) So raise those out-year projections. How much? Sorry, you're on your own. Or as the carnival barker says, "You pays your money and you takes your choice."

This much we will venture: 2-3 years ahead the deficit is likely to fall substantially from its present 4-5 percent or so of GNP. But it'll take a lot of luck to get below 2 percent again. And even 2 percent is a *big* deficit.



Copyright 1991 by The Conference Board.
Economic Times (ISSN 1050-0200) is published 10 times annually (July/August and Novegmber/December are combined issues) by The Conference Board, Inc., 845 Third Avenue, New York, N.Y. 10022-6601. Printed in Alpha, New Jersey. Second-class postage paid at New York, N.Y. and other mailing offices. POSTMASTER: Send address changes to Economic Times, 845 Third Avenue, New York, N.Y. 10022-6601. Editor: Edgar R. Fiedler

The Conference Board, 845 Third Avenue, New York, New York, 10022
The Conference Board Europe, Avenue Louise, 207 - Bte 5, B-1050 Brussels, Belgium
The Conference Board of Canada, 255 Smyth Road, Ottawa, Ontario, KIH-8M7

Colloquium

Background:

In the Gulf, the early action in the ground war suggests a quick and decisive Allied sweep. And the Iraqis are at least talking about withdrawing. Thus prospects for an early victory by the Coalition forces are favorable.

Question:

If the war does wind down to a successful conclusion soon, how will that change your view of the economic outlook?

Stephen H. Axilrod
Nikko Securities International

A successful conclusion of the war would change my view of the economic outlook only a little. There may be a pick-up in confidence that spurs some consumer spending. And oil prices and inflationary pressures will be lower than if the war persisted. But given various structural problems in the economy and the strong likelihood that a 1980s type consumer boom will not be repeated, the economic recovery is still likely to be more sluggish than the norm.

John T. Dunlop
Harvard University

Consumers are bunkered down. Governments are in deficit everywhere and squeezing for higher taxes (fees). Real incomes are down; automatic stabilizers are in poor shape. Housing and real estate are comatose, and gun-shy bankers are unwilling to accept an active expansion role despite Fed action. There is no leading region. Lower oil prices and exports may help, but the international world is seeking capital to rebuild and modernize. The year 1991 is shot.

Charles L. Schultze
The Brookings Institution

A long war would imply enough success on Saddam Hussein's part in giving the United States a black eye that, even if ultimately defeated, he could become a focus for instability in the Middle East. The long-term economic consequences, by way of potential large instability in oil prices and supply, could be very serious. A short war would thus be good for the long-term economic outlook.

Charls E. Walker
Charls E. Walker Associates

Claims to the contrary notwithstanding, Hussein's invasion of Kuwait did **not** cause the recession, nor will an early and favorable conclusion to the war end it. The U.S. today is paying for the fiscal sins of the 1980s. Since a major result of those sins is minimum "wiggle room" for anti-recessionary fiscal and monetary policies, the only choice now is — regrettably — to hunker down and hope for the best.

Members:

Members of The Conference Board Economics Colloquium are: Stephen H. Axilrod, Vice Chairman, Nikko Securities International; Andrew F. Brimmer, President, Brimmer & Company; Don R. Conlan, President, Capital Strategy Research; Robert G. Dederick, Executive Vice President and Chief Economist, Northern Trust Company; John T. Dunlop, Lamont University Professor Emeritus, Harvard University; Lyle E. Gramley, Senior Staff Vice President & Chief Economist, Mortgage Bankers Association; Isabel V. Sawhill, Senior Fellow, The Urban Institute; Charles L. Schultze, Senior Fellow, The Brookings Institution; James Tobin, Sterling Professor Emeritus, Yale University; Laura D'Andrea Tyson, Professor of Economics, University of California, Berkeley; Charls E. Walker, Chairman, Charls E. Walker Associates; Murray Weidenbaum, Director, Center for the Study of American Business; Albert M. Wojnilower, Senior Advisor, First Boston Corporation.

Japan and the United States: Can this Marriage be Saved?

by Rudolph G. Penner

Some Americans seem to need a new enemy to replace the Soviet Union, and some Japanese seem willing to oblige.

Now that communism is crumbling, some Americans seem to need a new enemy to replace the Soviet Union, and some Japanese seem willing to oblige. To these Americans, Japan seems a workaholic, unscrupulous trader bent on world economic domination. And to those Japanese, the United States seems a nation in relative decline filled with lazy, shortsighted overconsumers.

All this may seem like mindless emotionalism and it is. But it is beginning to permeate the intellectual and business leadership of both countries, fueling support for trade restrictions and retaliation. That makes it dangerous.

The Facts. The facts are not disputed even by the most virulent protectionists on both sides of the dispute:

- Even if Japan removed every protectionist element in its system the American bilateral trade deficit with Japan would be little affected.
- Japanese imports have widened U.S. consumers' choices and enhanced our living standards.
- Americans need Japanese capital to make up for our paltry savings rate. Without Japanese capital, American interest rates would be higher.
- The Japanese profit from both the openess of American markets and a safe, profitable haven for their excess savings.
- Most Japanese would benefit if their own markets were as open as ours.

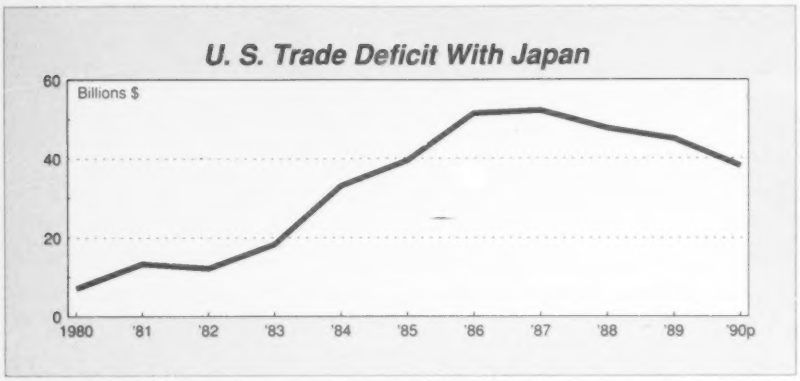
Obstacles. One would think that since such facts are not in dispute it should be easy to reduce tensions. But three major problems stand in the way.

First, Japanese protectionism is implicit. It stems from long established anti-competitive ties among Japanese businesses and government regulation. Even if the Japanese government honestly promises to reduce barriers, the promises are often worthless without the cooperation of Japanese bureaucrats and private decision makers.

Second, the U.S. Congress created a monster when it passed the Trade Act of 1986. The Act requires few substantive actions, but it requires reports on the sins of other nations. The "super 301" provision, for example, requires the Administration to name "priority" countries whose protectionism significantly affects U.S. exports. This might not be so bad if the United States were free of sin, but given our many protectionist measures it is downright sanctimonious. Worse, it deprives our international negotiators of an essential negotiating tool — subtlety in bargaining — while providing protectionists with an excuse to be self-destructive. The Administration is courageously refusing to label Japan a sinner this year because of progress in recent trade talks. The Congressional criticism of this move cannot help relations between the two countries.

Third, many noneconomists erroneously view trade as a battle in which you cannot win unless someone else loses--somewhat like competing in the Olympics. In such a frame of mind the nation can be seduced into taking great pleasure in expanding its market at the expense of its competitor's market share, even though "victory" may be economically costly. And people become morally outraged if competitors violate the rules of the game, even if the violations have little effect on the final outcome.

Our Economic Self-Interest. Nevertheless, when trade conflicts emerge the



general public occasionally shows that it can understand the theory of free trade quickly when economic self-interest comes into play. Here's an example: A TV reporter interviewed a woman buying clothes in a discount store. He pointed out that all the clothes were made in Asian countries. He further suggested that foreigners could compete unfairly by using cheap labor, and that such products should be banned. The woman agreed and became an instant protectionist. He then pointed out that the prices of such products would probably rise 20 percent in the absence of imports. "Well then I'd better rethink my position," said the woman. The instant protectionist was transformed into an instant free trader. This example illustrates an intuitive understanding of the basic principles of free trade:

- Importing goods increases competition, lowers prices, and so enhances our living standards.
- Importing capital allows our investment levels to exceed domestic savings, and so increases the productivity and real wages of our workers.

It would, of course, be foolish to argue that imports of goods and capital never cause problems, especially for particular industries. It is not surprising that the losers seek protection. Free markets are not painless, but as recent events in socialist countries illustrate, other systems are a good deal worse.

The Debate. The basic lesson emerging from international trade theory is that, with rare exceptions, it is in the selfish interest of a country to remove trade barriers even if other countries do not. Although many understand this lesson intuitively, it can be difficult to sell to noneconomists as an intellectual proposition. Two questions bedevil the debate. **If free trade is so wonderful, why can't you convince the Japanese?** The answer to this one is that the Japanese have, in fact, been slowly freeing up their economy.

The general public occasionally shows it can understand the theory of free trade quickly when economic self-interest comes into play.

If protection is so destructive, how have the Japanese been so successful? There is no contradiction between Japanese protectionism and their extraordinary growth performance. Protection may be costly, but it does not necessarily overwhelm other sources of growth. It must be remembered that the Japanese started from a very low level after World War II and they still are a long way from catching up. That in no way detracts from their great skill and extremely hard work, but one cannot help but wonder how long the miracle will last if they do not apply their own dose of perestroika.

Best Strategy. The first step for both countries is to avoid making false promises, which can only set back the cause of free trade further. The second is to continue to negotiate and press for concessions in return for making more of our own. Economic theory may teach us that Japanese protectionism is more their problem than ours, but in the current state of tensions that argument will not persuade Americans to accept Japanese trade restrictions or to lower our own trade barriers unilaterally.

"Marriage has many pains, but celibacy has no pleasures."

The most important theme motivating negotiations should be the constant reminder that the United States and Japan need each other. Both have benefited greatly from their cooperative relationship since World War II. Both face the challenges of radical developments in Eastern Europe and further economic integration of Europe in 1992. There are enormous potential gains to Japan and the United States from ensuring that the two developments are fully integrated into an efficient, freely functioning international economy.

Those who demand a more confrontational approach to Japan should think through the implications of an all-out trade war. Suppose the United States retaliates against Japanese imports and Japan counters with restrictions on Japanese investment in the United States. The potential disruption could be disastrous.

It is time to cool the emotions and dampen the rhetoric. We really do need each other. In the words of Dr. Johnson, "Marriage has many pains, but celibacy has no pleasures."

Excerpted from the June 1990 issue of *Policy Bites*, a bi-monthly commentary from the Urban Institute.

On Foreseeing the Unforeseeable

By Henry Kaufman

Projecting the future as an extension of the recent past oversimplifies the complexities of economic life and obscures important trends.

Undoubtedly, a modern-day rating agency would have accorded the dinosaurs the highest credit rating.

In making economic judgments, the future is very often projected to be an extension of the recent past. But these surprise-free scenarios simultaneously oversimplify the complexities of economic life and obscure important trends and changes that influence the longer term.

To illustrate the problem of perceiving fundamental or longer lasting change, I want to examine a few pages from history. Could a reasonable person, armed with today's analytical skills, have been expected to foresee the changes that took place?

At the dawn of history, life was dominated by huge dinosaurs, fifty-foot crocodiles; the sea swarmed with twenty-foot lizards. The mammals, small and shrew-like, hid in the thickets and grasses during the day and ventured out only at twilight or in the dark. Undoubtedly, a modern-day rating agency would have accorded the dinosaurs the highest credit rating and given no rating at all to the frightened mammals. Today, of course, the dinosaurs are extinct and mammals are the dominant life form.

How many living in biblical times were able to perceive the far-reaching impact that the Ten Commandments would have on the morality and behavior standards of much of mankind?

Perhaps these illustrations are too remote. More recently, then, how many people living in the nineteenth century would have made a correct judgment about the rise of the United States to world leadership? Textbooks often describe nineteenth-century America as a succession of excesses and calamities. The economy is pictured in terms of wild speculation, knavery, and irresponsible finance. In one panic, fourteen railroads went into bankruptcy, and in another, 600 banks failed. Nevertheless, it was during this century that the West

was settled and developed, massive railroad constructions took place, prosperity was occasionally spectacular, and the United States began to blossom into an industrial giant.

At the close of World War II in 1945 how predictable was the spectacular recovery staged by Germany and Japan? Or the rapid growth of multinational corporations and the development of international financial networks?

There is simply no scientific procedure that yields accurate economic judgments about the long term. Yet, if we are to make economic progress, we must persist in this effort.

These remarks by Henry Kaufman, president of Henry Kaufman & Co., a money management firm, are excerpted from his commencement address at the Columbia Business School, May 1990.

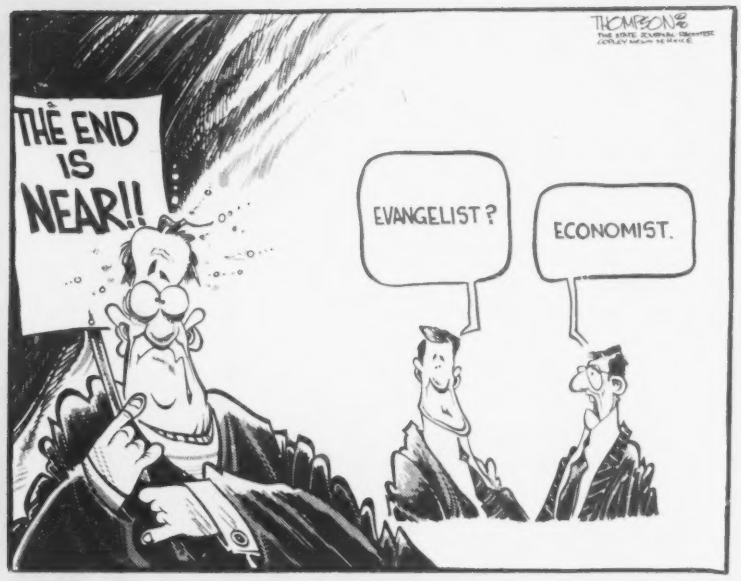
Quotable Quote

by Virgilio Barco, President of the Republic of Columbia

Just as history will recall the 1980s as an era when democratic forces swept the globe, it will also be remembered as a decade of resurgence in free market economics. This is a revolution of enormous significance, a recognition of our global economy, and a confirmation that open economies with access to markets can lead to social progress. It seems that the long-running match between Karl Marx and Adam Smith is finally coming to an end. I applaud this development, but at the risk of sounding passe, let me issue a warning.

In our rush to embrace free market forces, let us not lose sight of the fundamental role of government, as it embodies the free and collective will of its people. There is a role for both market forces and the state in solving social problems. Free market policies should not be used as an excuse for the lack of political will, whether it is assuring justice and fighting drug trafficking or providing basic education and health care. Free market economics is not a magic wand which somehow will relieve us of the obligation to care for our fellow human beings.

Excerpt from President Barco's commencement address at the Massachusetts Institute of Technology, June 1990.



With Permission of the State Journal-Register, Springfield, Ill., and Michael Thompson.

On an ordinary day in the United States:

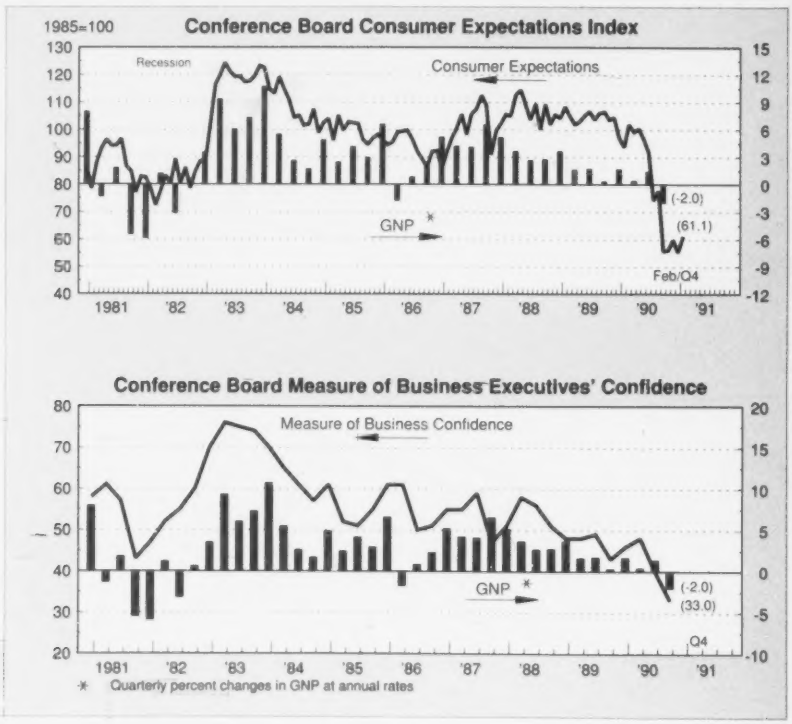
- Americans take 80 million aspirin tablets.
- 2 million is spent on exercise equipment and $3.5 million on tortilla chips.
- Four people call Graceland and ask to speak to Elvis.

(from Stanats Communications "Newsletter")

Conference Board Stat File

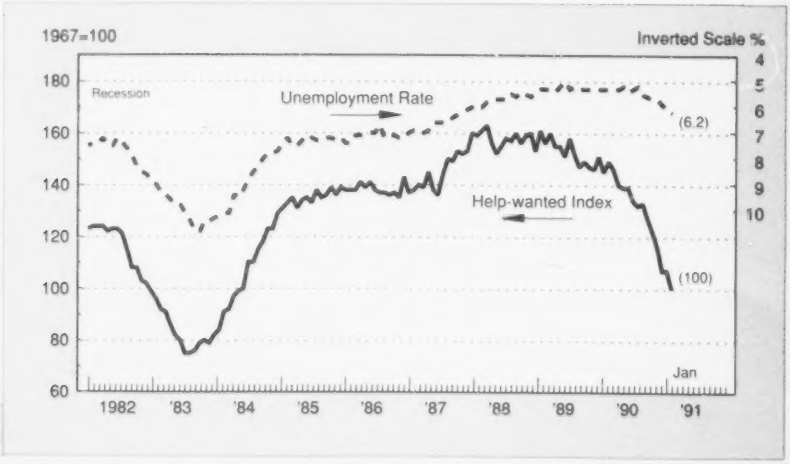
Just as the Gulf War proceeded on schedule, so does the recession. Most of the recently reported statistics, including, for example, The Conference Board's help-wanted advertising index below, show the downswing continuing apace. Here and there some modest encouragement appears: The consumer expectations index below and the diffusion indexes on the next page have stopped falling. And stock prices advanced sharply again in February. These favorable signs, however, are not yet sufficiently widespread to be read as harbingers of an early upturn. From here, the best bet still calls for the cyclical downswing to continue until the middle months of the year. *(Note: Data for Conference Board series in this section are available upon request from Ken Goldstein at 212-339 0331.)*

Confidence



No Decisive signal of a recovery in confidence can be seen yet.

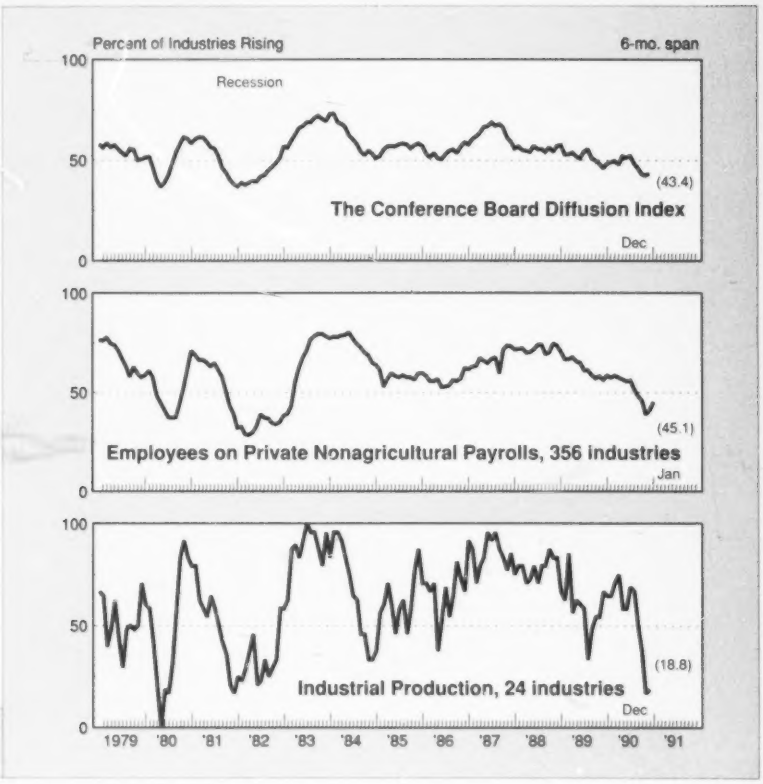
Help-wanted Advertising and Unemployment



Labor markets still weakening.

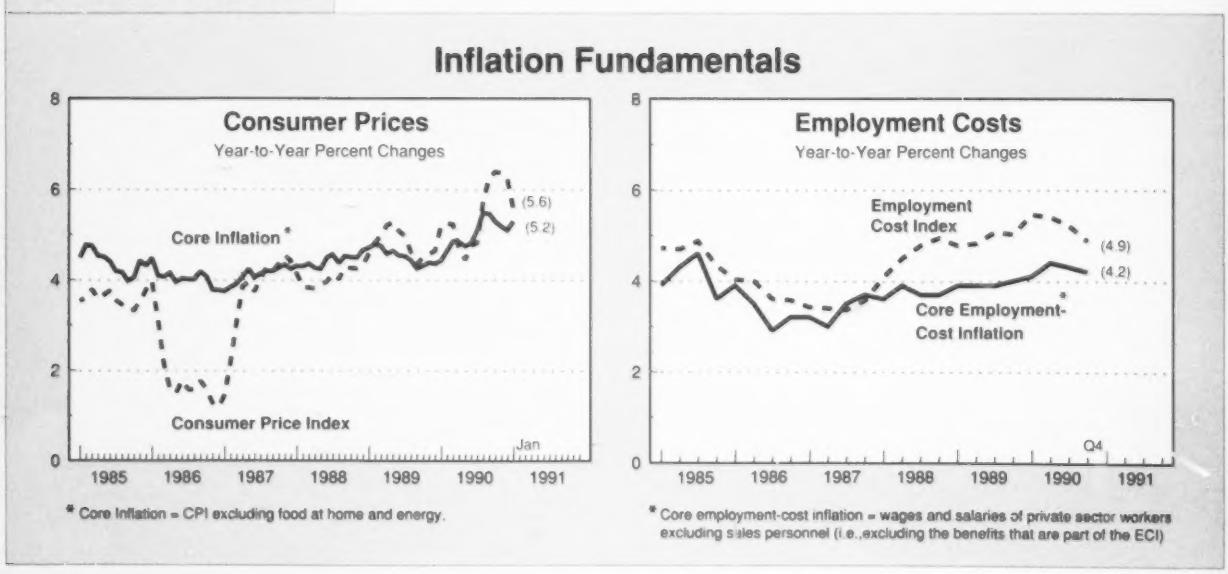
Conference Board Stat File

Indexes of Economic Momentum

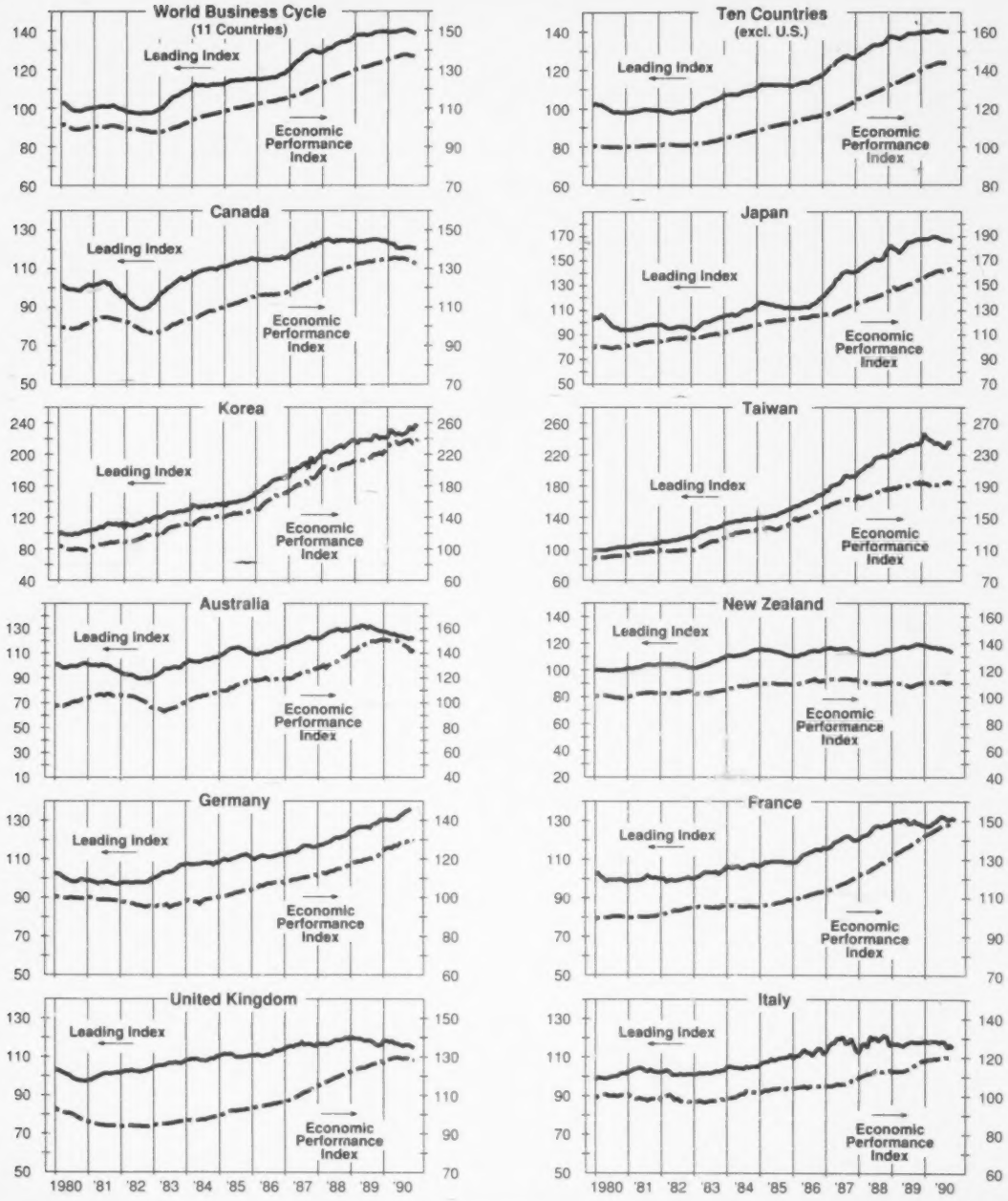


First hints seen of the bottoming in cyclical momentum.

Inflation momentum persists.



A Nearly World-Wide Recession



Cyclical weakness is spreading throughout the industrial world. The first and most serious (thus far) recession began a year ago January in Australia. The other two countries currently in recession are Canada and the United States. Three others — The United Kingdom, New Zealand and Taiwan — seem to be on the verge of recession. Japan, France and Italy give off ambivalent signals; their leading indexes hint at a downturn, but their performance indexes have continued to climb. The two main exceptions are Germany and Korea, where both indexes continue to show strength.

(Source: Indexes from the Center for International Business Cycle Research at the Columbia Business School, as published in the Conference Board's monthly *International Economic Scoreboard*.)

Inside the Crystal Ball

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	NORTHERN TRUST	CONF. BOARD	EATON	L.H. MEYER	DRI	WEFA		
Date of Forecast		Feb.	Feb.	Feb.	Feb.	Feb.	Feb.	Feb.	Feb.	Feb.	Feb.		
Gross National Product													
(Quarter-to-quarter percent change, constant dollars, seasonally adjusted at annual rates)													
		%	%	%	%	%	%	%	%	%	%		
Actual	1990 3Q	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	3Q 1990	Actual
	4Q	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	4Q	
Forecast	1991 1Q	-2.9	-1.6	-1.6	-3.2	-1.2	-0.7	-1.7	-1.3	-1.8	0.7	1Q 1991	Forecast
	2Q	-2.1	-2.5	-1.2	-0.1	1.4	2.7	3.7	0.5	-0.0	5.6	2Q	
	3Q	0.8	0.4	1.7	1.3	2.9	1.2	4.3	2.5	3.7	4.5	3Q	
	4Q	5.3	3.1	2.4	1.7	3.0	1.6	3.1	2.6	2.7	3.9	4Q	
	1992 1Q	7.8	3.0	3.2	2.7	3.0	2.4	4.2	2.8	3.6	1.8	1Q 1992	
	2Q	4.7	3.0	4.0	3.6	3.2	1.8	2.4	2.7	4.5	1.7	2Q	
	3Q	3.9		4.4	2.5	3.2	2.2	1.8	2.6	3.5	2.7	3Q	
	4Q	2.9		4.1	2.8	3.0	2.4	1.7	2.7	2.4	2.1	4Q	
	1993 1Q	2.0		3.8			2.4	2.5	3.0	2.8	2.5	1Q 1993	
Inflation (GNP Deflator)													
(Percent change from same quarter one year earlier)													
Actual	1990 4Q	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	1990 4Q	Actual
Forecast	1991 4Q	3.2	4.2	3.6	4.0	4.1	4.2	2.8	2.9	2.9	2.8	1991 4Q	Forecast
	1992 4Q	2.6		3.9	4.1	4.0	4.6	2.7	2.5	3.0	3.4	1992 4Q	
Unemployment Rate													
(Percent, quarterly)													
Actual	1990 3Q	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	2Q 1990	Actual
	4Q	5.9	5.9	5.9	5.9	5.9	5.9	5.9	5.9	5.9	5.9	4Q	
Forecast	1991 1Q	6.7	6.5	6.4	6.4	6.4	6.3	6.7	6.3	6.5	6.3	1Q 1991	
	2Q	7.2	7.0	6.8	6.8	6.7	6.4	6.9	6.6	6.9	6.2	2Q	
	3Q	7.4	7.1	6.9	7.0	6.6	6.5	6.9	6.7	7.0	6.2	3Q	
	4Q	7.1	6.9	6.8	6.9	6.5	6.6	6.8	6.7	6.9	6.1	4Q	
	1992 1Q	6.5	6.6	6.7	6.7	6.4	6.5	6.6	6.6	6.8	6.1	1Q 1992	
	2Q	6.2	6.5	6.5	6.5	6.3	6.5	6.5	6.4	6.5	6.1	2Q	
	3Q	5.9		6.3	6.3	6.2	6.4	6.5	6.3	6.3	6.1	3Q	
	4Q	5.8		6.1	5.9	6.1	6.4	6.5	6.1	6.2	6.1	4Q	
	1993 1Q	5.8		5.9			6.3	6.4	6.0	6.0	6.1	1Q 1993	

Rebuilding the Financial Zoo

by Albert M. Wojnilower

The monetary monopoly exercised by the Federal Reserve is the anchor of our financial system. It is this monopoly that enables the Federal Reserve to keep a lid on monetary creation during booms and to prevent monetary contraction in times of business recession or financial crisis. Although financial in character, the Federal Reserve's monetary powers also constitute the essence of our safety net for the real economy.

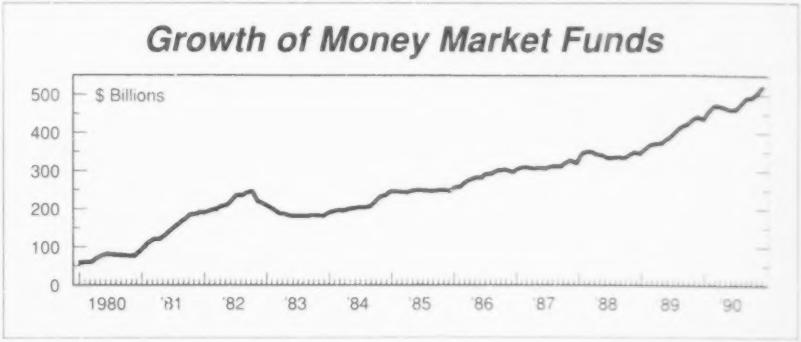
The better the money substitutes the financial service industry develops, and the greater the money-like liquidity it can provide for the broadest possible range of assets, the more it will prosper. Its way to success is through ingenuity in drawing the official safety net around private obligations. The private sector's chief incentive is to stretch and dilute the central monetary monopoly by creating financial claims whose convertibility into cash the Federal Reserve is expected to validate. Commercial banks had a head start by virtue of their effective monopoly on direct access to the Fed's discount window and exclusive franchise for the "sale" of checking accounts. The invention in 1962 of negotiable CDs, and later similar devices enabled banks to accumulate vast funds that from the holders' view remained immediately convertible into cash. But soon banks were hoisted by their own petard. Money market funds were able to persuade the public that they, too, were safe and instantly liquid. Since money market funds do not have to pay for deposit insurance, are free of other costly bank regulations, and do not need to process vast volumes of small checks, they have been able to skim the cream off the banks' personal deposit business (see chart).

Along another front, the banks and thrift institutions' loan business was siphoned away through the process labeled "securitization," which exploits the safety net in a different way. Another instructive form of securitization is the huge commercial paper market, in which large companies sell their unsecured short-term obligations to the public.

Let us look at this from an aggregate perspective. No matter how many financial institutions there are, they cannot on their own expand or contract the quantity of money. They may try, but the Federal Reserve has the job and the power to frustrate such efforts. In actuality, the Fed aims to maintain the long-run growth of money at a pace more or less equal to the sum of potential GNP growth and the acceptable rate of inflation. Absent inflation, this growth rate might be three percent a year at most. That unexciting rate would bound the growth of the financial sector, were it not for its considerable talents in erecting so marvelous a pyramid of assets, liabilities, and bets, and promoting faster trading and turnover in these instruments. But this inventiveness is self-limiting. When too successful, the new instruments drive the old out of circulation. Money market funds and commercial paper are superseding bank deposits much as, long ago, bank notes drove out the previous metal coinage.

One policy option is to let the diverse monies compete with one another, accepting the inevitable crises that occur when losers are culled. Another choice is to legitimate the new devices by making them eligible as, or convertible into money, while at the same time bringing their quantity and growth under monetary control. That is the core significance of the Federal Reserve's broadening of its monetary targets from M1 to M1B, M2, M3, and so forth. Of course there is a third option, which is to prohibit or regulate out of existence the new inventions, thereby confirming the existing monopoly.

If we want the central bank to prevent inflation and deflation, but private firms to make the microeconomic credit decisions, we must expect the private sector continually to develop instruments which undermine the monetary standard and impair the power of the central bank. In practice, we will intermittently have to choose between forbidding use of some innovations or broadening the monetary standard in such a way as to regulate them. Since every such candidate for monetary inclusion will have different private sponsors, these decisions cannot avoid a political dimension.



Despite their inherently disruptive nature, we should not prohibit innovations because that would mean foregoing technological gain in the financial industry. But we must understand that the combination of a central bank, a private financial sector, and innovation decrees an endless swinging back and forth between regulation and deregulation. Sometimes we will want to let in fresh to displace stale air, but when it gets too chilly, we will need to close the window. No automatic mechanism can do this for us. There can never be total absence of regulation because the underlying monetary monopoly is always eroding and in need of shoring up or redefinition.

The Monopoly is Fragmented

With this principle as background, let us examine the current difficulties of the American financial industry. As recently as the mid-1960s, it would have been correct to describe our financial system as a well-kept zoo. Different species, such as banks, securities dealers, insurance companies, and so forth, were neatly kept in separate cages segregated by function and geographical scope. The bars between cages prevented the various species from preying on one another. Within each cage, as in a real zoo, there was competition as respects the pecking order, access to the best food, and so forth, but vigilant keepers made sure this never led to serious injury or death.

Now this tranquil order has disintegrated. Many forces combined to undo the multitude of sheltered oligopolies. A major new element was the internationalization of the world economy. Another was the quantum leap in electronics, which rendered even more obsolete the geographical restrictions and generated new and cheap techniques (such as securitization) to provide services that cut across the traditional functional boundaries. The new technology became a means for the more ambitious institutions to engineer their escape.

But probably the chief source of change, stronger than internationalization or technology, was the shift in the prevailing ideology, which overtook animals, keepers, and public alike. Supervisors who not long before had zealously stamped out every small trespass lost faith in the validity of the regulations they were charged to administer and now condoned or even tacitly encouraged evasive techniques invented in the marketplace.

As recently as the mid-1960s, it would have been correct to describe our financial system as a well-kept zoo.

Deposit insurance and the other dimensions of the federal safety net always had posed a potential "moral hazard." They tempted lenders to take undue risks — heads, I win; tails, the government loses. Interest rate ceilings and the other competitive restraints, however, largely removed the incentive and the capacity for responding to the lure. Of all the competitive restraints, the ceilings on deposit and loan interest rates were probably the most constraining. These rules suffered severe attrition during the 1970s and were virtually repealed by the mid-1980s. Abrogation of the rate ceilings demolished the zoo, with predictably traumatic consequences.

On removal of barriers and reduction of subsidies, every denizen of the overpopulated zoo became both predator and prey. The interest rates they had to pay moved up faster than the rates that, with stiffer competition, they could charge. To preserve their size and growth, institutions had no choice but to compensate for squeezed profits by hungrily reaching for greater loan volume in unfamiliar markets. Lending standards eased everywhere. The inevitable result was a huge growth in debt, a significant fraction of which, equally inevitably, turned out to be unsound.

Meanwhile, the zookeepers continued to be held responsible for keeping alive most individuals of size, even though they might no longer be functional. More and larger casualties began to drop into the safety net, becoming a sizable drain on the public purse, the most serious instance so far being the wholesale collapse of the savings and loan industry. But unless vigorous preventive medicine is instituted, other parts of the financial sector surely will follow.

The thrift problem and its difficulties of resolution have much in common with the abuse and disintegration of state-run enterprises in the communist countries and Latin America. These institutions were in effect afforded open-ended calls on the public purse, a privilege they converted into huge windfalls for themselves (in the U.S., for homeowners and real-estate developers). But tearing down the institutions does not automatically generate others to take their place.

The natural reaction is revenge. Throw the rascals out! But the previous incentive structure, however antisocial, also attracted the most economically savvy individuals. Despite their alleged sins in responding to the incentives, they are possibly the most knowledgeable about doing the job better (and surely strategically placed to pursue a "scorched earth" policy against those trying to oust them). In the case of our S&Ls, the current political bloodlust is such that many persons experienced in real estate (analogous to communist factory managers) are effectively excluded from acquiring the properties the government wishes to liquidate. The government's agents also are afraid, because of the public's anger, to sell at prices low enough to allow the buyer to turn a profit. In effect, properties may only be sold to persons who don't know the business and certainly not at a price at which they might make money.

As the writedown of real estate values spreads through the country like a chain letter, other prominent real estate lenders such as banks and insurance companies

are sucked into the downdraft. Parts of the securities industry (notably the retail side) also are in moribund condition. Whether or not the Federal Reserve yet fully realizes this, it is in serious danger that lender-of-last-resort priorities will eclipse its monetary functions. There is a vast quantity of financial instruments whose conversion into money, at orderly or even fixed prices, has been explicitly or implicitly guaranteed by the authorities. Careless deregulation has allowed our financial fabric to become so closely interwoven that almost every financial instrument that is widely held and traded has to be protected.

The Authorities Make Matters Worse

Although central bankers might disagree with this statement of the situation, they are aware of the problem. But, the supervisory path they are following is suicidal with respect to the preservation of their monetary independence, and lethal to our financial system's ability to support a risk-taking and internationally influential private sector.

Financial institutions cannot compete. They cannot compete with nonfinancial businesses because their own aggregate growth potential is limited by national monetary targets. Because loss of confidence in any group of institutions can easily be infectious and because the safety net must and does protect at least the larger of the losing institutions, no significant segment of financial business can grow rapidly without soon causing serious systemic problems such as we are currently experiencing. The American financial zoo is especially vulnerable to collapse from internal competitive stress. There are simply far too many institutions being kept alive, for any of them to have decent earnings in a noninflationary environment.

How to Improve Current Policies

Current U.S. financial policy includes three strands each of which, although correct in ultimate intent, seems certain in practice to make matters worse. They are 1) encouraging institutions to broaden the range of their services; 2) forcing them to improve capital ratios; and 3) limiting the scope of deposit insurance. As presently pursued, they are doomed to fail, but the approach developed here suggests how they might be modified to give them a chance to achieve their good intentions. Firstly, as to the "decompartmentalization" of the industry, I fully concur that breaking down the barriers, whether geographical or functional (as, for example, the Glass-Stegall Act that separates the banking and securities business), is necessary and unavoidable. Indeed, I have reached the reluctant conclusion that interlocks with nonfinancial firms are desirable. More fundamentally, universal banking is desirable because it comes closest to insuring that financial change will develop within rather than outside the regulated sector.

Pushing house cats into the jungle is not liberation but murder.

But how to achieve this objective? Simply to allow or urge our existing financial institutions to universalize, as we are doing, is a recipe for disaster. It pushes the specialized animals out of their familiar cages to venture into others for which they have no experience and which are already overcrowded with species specially adapted to that environment. Pushing house cats into the jungle is not liberation but murder. Unless we want to risk a crisis, any program that intensifies competition must be accompanied by one that facilitates orderly exit.

Unpleasant as it may be, the government must offer sizable subsidies to force the liquidation or merger of existing institutions. The carrot would need to be substantial and so would the stick. After a stipulated deadline for taking up the exit subsidy, surviving institutions would lose the shelter of many anticompetitive regulations, and firms failing to meet capital standards would have their top managements automatically discharged and incremental deposits, insurance reserves, brokerage accounts, etc., declared ineligible for deposit insurance and other official backstops. The objective should be to decimate the number of firms, affording the survivors a reasonable prospect of profitable operation and capital access.

It would be expensive. But most observers would agree that this is how, long ago, the savings and loan problem should have been treated. It is, indeed, how we are dealing with it now, but at far greater expense than had we started sooner. The choice with respect to other parts of the financial industry is only whether to act now or to wait until we are forced to do the same things at greater cost in a crisis.

The second approach the authorities hope will mitigate the conflict between their macroeconomic and safety-net responsibilities is the enforcement of tighter capital rules. If bank shareholders had more at risk, it is argued, they would force managements to be more careful. Since the regulatory crunch rules out gathering capital by earning more through lending more, the only course left to banks to strengthen their capital ratios is to shrink assets. But there is simply no way for the financial industry to increase its aggregate capital except in a growth environment.

The gridlock has to and will be broken. In a world with no competing currencies or central banks, sharply lower interest rates might do the job, but that no longer is the world in which we live. Two steps are necessary. First, as was done during the mid-1980s oil price collapse, examiners should value properties not on current transaction prices, but on some longer-run average. ("Mark-to-market" is absurd in this context; for example, if all assets had been valued on the night of the stock market crash, October 19, 1987, most private firms would have been forced into bankruptcy. That, by the way, is what the bank examiners wrought in the 1930s.) Second, the Fed will have to im-

plement its national target for credit growth on the individual bank level. In a variation on "community action" standards, the authorities will need to require individual institutions to adhere to national or regional credit growth standards for at least that part of their loan book which has passed examiner inspection, granting them forbearance with respect to any adverse effect of such loan increases on capital-asset ratios. It is certain that less forbearance will be needed in such a growth environment than will turn out to be unavoidable under the current pressures for shrinkage.

The third and most explosively dangerous aspect of official policy is the attempt to narrow deposit insurance. Today virtually all liquid assets that are not **de jure** government guaranteed are held only because they are deemed to be guaranteed **de facto.** Indeed, holdings are shifting noticeably in the **de jure** direction. A widely publicized change in the rules, such as the proposed reduction in the number of permissible insured accounts, could easily turn the present stream of funds toward fully backed governmental securities into a torrent. The short-term result would be a credit crunch similar to the "disintermediation" crunches that used to occur when government security yields rose above the interest rate ceilings, leaving financial institutions helplessly exposed to a hemorrhage of deposits. Those episodes were easily stanched by a Fed-engineered drop in open-market interest rates. Financial intermediaries suffered liquidity drains, but these didn't last long enough for capital to be seriously impaired. One can only conjecture what heroic measures would be needed today to stop deposit bleeding due to capital inadequacy.

A run into government securities would lower their yields while rates soared on private obligations subject to credit risk. When the government can borrow freely and cheaply while the private sector can do so only with difficulty and at much higher rates, the channeling of capital flows and investment decisions through the government becomes a political certainty. In toying with deposit insurance, the authorities risk triggering a depression as well as the complete nationalization of the capital market.

One may have a great deal of sympathy for the government's effort. The authorities do ultimately have to prevent the limitless stretching of the safety net, but this is difficult to accomplish when confidence is low. The objective is to draw boundaries for the safety net, but it has to be done without panicking all the people who live on or outside the boundaries into destructively rushing inside. One suggestion for moving gradually in this direction would be to abolish the $100,000 limit on deposit insurance, while imposing an interest-rate ceiling on insured accounts at a level lower than government-security yields at corresponding maturities.

The objective should be to decimate the number of firms, affording the survivors a reasonable prospect of profitable operation and capital access.

In Short

This essay has attempted a far from complete or precise effort to define some principles for the operation of our financial system and to draw some practical consequences from them. The economic and financial safety net is a marvelous human invention, but cannot be all encompassing without subverting monetary stability. It is desirable, in principle, that the boundaries of the safety net be sharply demarcated. In practice, however, an alert and technologically advancing private sector continually creates innovations that attempt to accelerate monetary and credit growth beyond the national standard by blurring and stretching these boundaries. Some but not all of these innovations are worthwhile. They should not, however, be allowed within the net unless and until provision is made for the orderly closing down or expulsion of the obsolescent process the innovation displaces. As a counsel of perfection, this can best be accomplished in a system composed of a few giant "department stores" of finance, which are de facto guaranteed perpetual life but expected to maintain significant birth and mortality rates among their departments.

The American financial system, by contrast, consists of a large number of specialized stores, many or most of them unlikely to survive. This puts in doubt the credibility of the safety net, since a misconstrual of its borders, either by the public or the authorities, could trigger a cascade of defaults. The danger is growing of an implosion of the private financial sector into an entirely government guaranteed market, in which the extent and nature of government underwriting becomes the chief arbiter of private credit access. Intentionally or not, current supervisory policies are intensifying rather than mitigating this risk. I have offered the suggestion to subsidize the exit of sick institutions, enabling them, as it were, to retire or be absorbed rather than die; to use the supervisory function to promote the growth rather than the shrinkage of the stronger institutions; and to make a cautious start at remarking the limits of the safety net, by insisting that the public accept lower than government-security interest rates on fully-insured deposits.

Albert M. Wojnilower is Senior Advisor, First Boston Asset Management. This essay is excerpted from a paper he delivered November 30, 1990, at the Fourth Special Financial Conference sponsored by the American Committee on Asian Economic Studies, in cooperation with the Federal Reserve Bank of San Francisco, and the University of California at Berkeley.